



wts

Royalty  
Matters

# Forewords



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## Royalty matters

- Legal review
- Tax review
- Customs review
- Foreign exchange review

## Royalty matters

Royalty charges are common in many businesses in China. It is a charge over the use of intellectual property (IP), against affiliates or non-affiliates. Much of the due diligence review has focused on its legal implications concerning ownership and protection.

Royalty charges between related parties are regularly subject to official scrutiny. Unfortunately, review is often insufficient in other equally risky areas, particularly in China tax, customs and foreign exchange areas. Some companies have learnt the lesson in a hard way and regretted that their life could be easier if they have done a professional review holistically:

In this special issue, based on some recent royalty cases WTS China handled, we provide a crash course on the following:

- What you need to know?
- See what happened.

We hope that it serves you well in achieving a better risk management.

Yours faithfully,

A handwritten signature in black ink, appearing to be 'M Ng', written in a cursive style.

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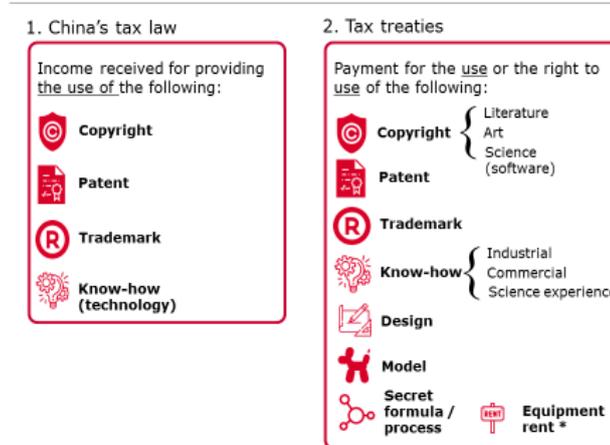
## What you need to know?

### Tax review

Each royalty agreement, for its enforcement, is required to be submitted for a formal registration and review. Further, its China tax liability varies from category to category.

Royalty is much more broadly defined by China's tax treaties than its domestic income tax law. In other words, be aware that some charges seemingly not called royalty could be taxed as royalty when comes to cross-border payments.

In general, royalty payments to overseas (China-sourced income to oversee parties) are subject to China withholding tax (WHT) VAT and stamp duties.



Tax review should aim at checking not only what formalities govern it, what China taxes apply, when they are due, if the charge is levied at an arm's length, but also in particular if it can stand against any "base erosion and profit shifting" (BEPS) challenge raised by a China tax authority.

BEPS challenge can be on pricing level, beneficial ownership, rationale, tax effects, and substance, etc. BEPS test poses the foremost challenge, and is the main culprit to the failure of a royalty agreement.

Common Failure in Tax
1. Failure to pass BEPS test
2. Failure to pay taxes
3. Failure in documentation
4. Failure in procedures

One should not assume that a Chinese tax authority, in a BEPS enquiry, can be simply appeased by tax revenue. It can be costly or too late to revise a royalty agreement found to be BEPS non-compliant. It goes without saying that a full tax review should be done upfront.

Interestingly, the customs laws cover a broader scope of "royalty" than the tax laws. Payments for distribution right and sales right can also fall prey to customs duties, if meeting the customs criteria.

### Customs review

It sounds incomprehensible that a royalty can be subject to import duty and VAT – yes it can, if it is related to imports and forming a condition to the sales in China (being the two criteria set out in China's customs laws). It is never over-emphasized that the customs consequences can be even more serious than the tax consequences, when the duty rate is high and previous years' royalties are retroactively taxed.



Yet, the customs review is the most neglected work, as we observe. The negligence is mainly attributable to the insufficient knowledge on China customs laws and oversight to customs risk.

Among some past instances confronted by the customs bureau for import duty and VAT, we see that they could be avoided if a proper customs review is done.

In one case, for example, equipment parts bearing a corporate logo were imported into China by a Chinese subsidiary from its overseas parent company. In parallel, a royalty fee was paid to the parent company by the Chinese subsidiary for using the logo.

Unfortunately, the royalty was charged by the Customs as related to imports due to the logos printed on the parts, and as a result heavy duty was levied.

As a matter of fact, after the assembly, these parts are all embedded inside an equipment and the logos are no longer visible, nor commercially necessary. To mitigate customs duty risk, the logos on the parts can always be replaced by non-logo marks or serial numbers instead.

The trickiest task in scoping a royalty agreement is to make both ends meet – striking a balance between customs and tax risk. A poor scoping will result in double taxation, in tax and customs.

### Foreign exchange review

A royalty agreement that cannot effectuate a payment out of China is a useless agreement. This happens often in China. A common misapprehension is that a Chinese bank will entertain all remittance requests, without realizing that foreign exchange control measures are in place in this country.

All Chinese banks are mandated by State Administration for Foreign Exchange (aka SAFE) to process cross-border funds strictly in line with SAFE rules. They are required to scrutinize a royalty agreement and its supporting documents, from a “*know your client’s business*” perspective – an entirely different approach from that of the tax and customs authorities. The process can be inflexible and time consuming.

SAFE has also imposed uncompromising practices on payments. If a royalty payment is seriously overdue, it could be subject to further enquiry; if interests are chargeable on late payments, they have to be paid together with the principles (and extra China tax liabilities for the interests have to be filed too). Minor oversights in these processes can easily lead to mishaps.

In other words, a perfect royalty agreement can still result in a payment failure for a poor implementation in foreign exchange areas.

## See what happened

Don’t assume that royalty arrangements can escape the radar of the authorities. They came into light easily in the following events:

- Royalty agreement registration;
- Import declaration data that requires the disclosure of any royalty payment;
- Finance statements submitted annually to the authorities;
- Large-scale checks by C Customs (like the one in 2017 shown below).

### 海关总署（司）局函

稽查函〔2017〕9号

加急

稽查司关于进一步推进特许权使用费专项稽查工作的通知

*“Urgent Notice on Launching Inspections against Royalty Charges” by China Customs*

**Case 1 (2019):** A manufacturing company has mistakenly submitted a voluntary disclosure to a local customs authority, confessing (though technically unfounded) that its royalty payments for the past years should be dutiable. It led to a toll of RMB 1.5 million. WTS China helped in raising an administrative appeal (the first of its kind in China) and at great length won the case to rescind the duty charges.

**Case 2 (2017):** A Shanghai-based food ingredient wholesaler, making an annual royalty payment over CNY 10 million to its Luxemburg parent company, has received an enquiry from Shanghai Customs on its business model and royalty payments. WTS China stepped up a defense which has silenced the Customs ever since.

**Case 3 (2017):** An Italian fashion retailer has its royalty payments challenged by a district tax bureau in Shanghai for its year-end compensation terms. WTS China advised on an improvement and has the issue resolved, just shortly before it has to close its annual accounting books.

In conclusion, a holistic review on a royalty arrangement is an answer to the problem.



## About WTS

WTS is an international, integrated and independent consulting group. Through our network we are represented in more than 100 countries worldwide. Within our service portfolio we are focused on tax, legal and consulting. In order to avoid any conflict of interest, WTS deliberately refrains from conducting annual audits.

Our staff has various backgrounds ranging from corporate tax departments to tax authorities and international consulting firms. WTS' clients include multinational groups, medium-sized companies, non-profit organizations and private clients. Our International Project Consulting (IPC) group is experienced to operate cross-border together with our WTS network partners.

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